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## Limitations of Corporate By-Laws

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stockholder until reclassification reaches that degree of unfairness where it amounts to a cancellation of the preferred stockholders' accumulated unpaid dividends without adequate compensation therefor under the law either by way of a share in the equity of the surviving corporation or the payment of money. At such a point a court of the United States might grant injunctive relief under the provisions of the Fourteenth Amendment." The right of appraisal, which is the only practical way allowing adequate compensation to the dissenting stockholder, is provided for in the law.

We must be careful, however, to afford the minority stockholder an adequate measure of relief at all times on the ground of fairness to all. Since his only recourse is to a court of equity when he has not received dividends, we should make this path one not too difficult nor fraught with too many financial hazards. Otherwise court review and judicial scrutiny will become far from a potent weapon. Today with Section 61-b<sup>24</sup> of the General Corporation Law imposing rather severe and arbitrary financial prerequisites on a minority plaintiff, we have definitely diminished his safeguard, and as a result may allow unscrupulous corporations to take advantage of our interpretation of Section 36 to the detriment of the minority stockholder.

KATHARINE CURNEN MULLEN.

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#### LIMITATIONS OF CORPORATE BY-LAWS

The by-laws of a corporation have been called the rule of its life. It is usually the first and most important duty of the stockholders to adopt them; it is a matter of practical if not legal necessity. The power resides in the stockholders, though they may delegate it to the directors.<sup>1</sup> At common law the power to make and adopt by-laws was inherent in every corporation as one of its necessary and inseparable legal incidents.

In New York, the power to adopt by-laws is expressly authorized by Section 14, Subdivision 5, of the General Corporation Law.<sup>2</sup> The

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<sup>24</sup> Section 61-b of the General Corporation Law provides as follows:

"Security for expenses.

In any action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five per centum of the outstanding shares of any class of such corporation's stock . . . unless the shares . . . have a market value in excess of fifty thousand dollars, the corporation . . . shall be entitled . . . to require the plaintiff . . . to give security for the reasonable expenses . . . ."

<sup>1</sup> 8 FLETCHER, CYCLOPEDIA OF CORPORATIONS (1931) § 4166.

<sup>2</sup> "Grant of general powers.

Every corporation as such has power though not specified in the law under which it is incorporated: . . . (5) to make by-laws, not inconsistent

power to amend such by-laws is inherent in the shareholder, and an incident of the power to adopt. However, the power to amend, like the power to adopt, is circumscribed and subject to limitations. The requisites of validity may be enforced by the courts with much greater strictness as regards an amendment because of the possible existence of vested rights and a status predicated on the pre-existing by-law.

Unusual interest attaches to the power of stockholders to amend by-laws and the limitations imposed thereon by law and sound judicial reason, in view of the recent decision of the New York Court of Appeals in the case of *Benintendi v. Kenton Hotel Co.*<sup>3</sup> This was an action by a minority stockholder of the Kenton Hotel Company to restrain the holding of a special meeting and to have certain amended by-laws adjudged valid and in full force and effect. These by-laws provided in substance as follows: (1) no resolution of stockholders should be adopted except by unanimous vote of all the stockholders; (2) election of directors must be by unanimous vote of all the stockholders; (3) no resolution of the directors should be adopted except by unanimous vote of the directors; and (4) by-laws may be amended only by the unanimous vote of all the stockholders. The Court of Appeals held that the first two by-laws were invalid as "obnoxious to the statutory scheme of stock corporation management," and contravened an essential part of state policy, *i.e.*, that "receipt of a plurality of the votes entitles a nominee to election." The third by-law was also held to be invalid not only on the ground that it was almost as a matter of law unworkable and unenforceable but also because it impinged upon the common law concept of management of a corporation by a majority of a quorum of the board of directors, which concept is expressed in Sections 27 and 28 of the New York General Corporation Law. The fourth by-law, although not authorized by any statute, was nevertheless held to be valid on the ground that a corporation need not provide any machinery at all for amending its by-laws and "once proper by-laws have been adopted the matter of amending them is no concern of the State."

An almost parallel decision was handed down by the Supreme Court of Virginia at about the same time in *Kaplan v. Block*.<sup>4</sup> The court held that the plaintiff, Secretary-Treasurer-Stockholder, who

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with law, for the management of its business, the regulation of its affairs, the transfer of its stock, if it has any, and the calling of meetings of its members. Such by-laws may also fix the amount of stock, in the case of stock corporations, or the number of members, in the case of non-stock corporations, which must be represented at meetings of the stockholders or members to constitute a quorum unless otherwise provided by law. By-laws duly adopted at a meeting of the members of a corporation shall control the action of its directors except as otherwise provided. . . ." This grant of power to stockholders is further clarified in General Corporation Law, Sections 19, 21, 23, 27 and 27a; and in Stock Corporation Law, Sections 45, 46, 55, 57, 60 and 65.

<sup>3</sup> 294 N. Y. 112, 60 N. E. (2d) 829 (1945).

<sup>4</sup> 183 Va. 327, 31 S. E. (2d) 893 (1944).

had been removed from office by a majority vote of the directors, was not entitled to mandamus to compel reinstatement on the ground that the officer-plaintiff had voted against such removal, and that the corporate charter and by-laws required all acts of directors to be approved by a unanimous vote, since such charter provision and by-laws were invalid. The charter contained a provision that any matter concerning the administration and management of corporate affairs could only be determined by unanimous vote of all the stockholders; the by-laws in question provided that Class A common stock (the only stock having voting power) "shall have the sole voting power, but no act of the stockholders shall be valid or binding upon the corporation or stockholders unless such Class A stock be voted unanimously."

Justice Holt held both provisions invalid not merely because they were inconsistent with various sections of the state code but also on broad grounds of reason and logic. Said the court: "Under the charter and by-laws no action of the board of directors not approved by the stockholders is effective and to make bad matters worse, it must not only be approved by them, but must be unanimously approved by them. For all practical purposes there might as well be no board at all." And further in his opinion he sets down a rule of great significance: "In construing corporate charters, by-laws, and powers granted, their validity is determined not by what has been done under them, but also by what may be done."

In denouncing the danger that lurks in the specious doctrine of unanimity as applied to corporate activities the court furnishes us with a vivid and compelling illustration:

A recalcitrant director who is also a stockholder may embalm his corporation and hold it helpless: it can do none of those things noted as authorized by general law. It cannot sue and it cannot defend a suit. It cannot be dissolved and it must remain forever in a state of suspended animation. A treasurer who chanced to own a share of stock might pocket its assets and leave his associates without civil remedy. These regulations if followed out, violate both common and statute laws and are suicidal of corporate existence. A board of directors whose every act must be endorsed by every stockholder is no board at all . . . right after right is violated. No suit can be brought without a dissenter's consent, nor can two-thirds of outstanding stockholders elect to go out of business. To ask that directors be divested of all power, and that without the consent of every stockholder, no one should have power to do anything is to ask too much.

This is a powerful and convincing argument. In the absence of a contrary statutory provision one wonders why this reasoning should not apply with equal force and vigor to a by-law demanding that no by-law may be amended except by the unanimous consent of all the stockholders. Such by-law is squarely against the whole concept and nature of the corporate entity wherein control must rest in the corporation itself. Majority or two-thirds control is the orbit around which the corporate body revolves; to place that power either by default or otherwise in the hands of a sole dissentient vote, for any purpose whatsoever grave or merely trivial, seems to be tantamount

to raising up within the corporation a power greater than itself.

The common law, dicta in innumerable opinions, and the history of corporations seem clearly to uphold this position. Lord Coke expressly states that in public corporations the majority should rule. As early as 1820 Chancellor Kent pointed out<sup>5</sup> that corporations were invented to circumvent the unity required in partnerships, and that the right of the majority to rule was one of the chief differences between corporations and partnerships. The fair inference from this is that to the Chancellor the proviso of mandatory unanimity in amending corporate by-laws would have seemed unreasonable. For are not the by-laws the corporation's "rule of life" and even its "bill of rights"<sup>6</sup>—are not the stockholders and directors subject and bound to them and unable to operate unless within their ambient?

Second only to their legality in the nature of things they must be reasonable, since when duly adopted the by-laws are as much the law of the corporation as the charter itself,<sup>7</sup> and by-laws must not only be reasonable in themselves, they must not be unreasonable in their practical application;<sup>8</sup> it is a general essential of their validity that by-laws shall be reasonable and not arbitrary or oppressive.<sup>9</sup> Even when the power is delegated to the directors they must not overstep this boundary.

While the courts of New York have accepted a policy of not pursuing a by-law further than to inquire whether or not it is inconsistent with law<sup>10</sup> other courts in sister states have gone much further, as illustrated by the rule of the Supreme Court of Virginia, *supra*.<sup>11</sup>

The power to make by-laws is a continuous one, and no one has a right to presume that they will remain unchanged.<sup>12</sup> For all practical purposes mandatory unanimity in amending a by-law may be the equivalent of the corporation binding itself not to amend its by-laws and "there is authority for the proposition that a corporation cannot bind itself not to amend its by-laws."<sup>13</sup> As laid down in

<sup>5</sup> *Livingston v. Lynch*, 4 Johns. Ch. 573 (N. Y. 1820). See also *Kirkpatrick v. Abrahams*, 98 Kan. 685, 159 Pac. 13 (1916).

<sup>6</sup> "By-laws of a corporation when legally adopted, which are reasonable and fair in character have the force of law within the corporate body. Such by-laws are the bill of rights of a corporation." *Matter of Flushing Hospital*, 27 N. Y. S. (2d) 207, *aff'd*, 262 App. Div. 749 (1941).

<sup>7</sup> *Kavanaugh v. Commonwealth Trust Co.*, 223 N. Y. 103, 119 N. E. 237 (1918).

<sup>8</sup> *Mancini v. Patrizi*, 87 Cal. App. 435, 262 Pac. 375 (1927).

<sup>9</sup> *Van Poucke v. Netherland St. Vincent de Paul Society*, 63 Mich. 378, 29 N. W. 863 (1886).

<sup>10</sup> "The courts will not pursue the investigation of the validity of the by-law further than to inquire whether it is inconsistent with the laws of this state." *Matter of Amer. Fibre Chair Seat Corp.*, 241 App. Div. 532, 272 N. Y. Supp. 206 (1934). See also *People ex rel. Muir v. Throop*, 12 Wend. 183 (N. Y. 1834).

<sup>11</sup> See note 4 *supra*.

<sup>12</sup> *Steen v. Mod. Woodmen of America*, 296 Ill. 104, 129 N. E. 546 (1920); *Farrier v. Ritzville Warehouse Co.*, 116 Wash. 522, 199 Pac. 984 (1921).

<sup>13</sup> *Saltman v. Nesson*, 201 Mass. 534, 88 N. E. 3 (1909).

*Manson v. Curtis*,<sup>14</sup> "clearly the law does not permit the stockholders to create a sterilized board of directors"; however, this result might easily occur if an impeding by-law could not be amended except by unanimous consent. As the court said in *Field v. Eastern B & L Ass'n*,<sup>15</sup> "Lawful adoption may mean much or little. Rules may be adopted under the forms of law that might nevertheless be so unreasonable and inequitable as to be clearly beyond any possible contemplation of law." Even the power to contract is not unlimited and there seems good reason why the power to make by-laws should not be so.<sup>16</sup>

Since the concept of unanimity (*i.e.*, mandatory as distinguished from accidental or voluntary unanimity) is so at war with the very nature and essence of the corporate entity we think the sounder view is that expressed in the following cases. In *Richardson v. The Union Congregational Society of Francesdown*,<sup>17</sup> the court invalidated a by-law requiring a two-thirds vote of the members present to alter or amend its laws. The court held such action inoperative and said it might be modified or repealed by a majority vote at any regular meeting of the Society. "Equity," said the court, "will not enjoin a religious society against using a by-law which requires a vote of two-thirds of the members present and voting, to admit new members, even though such by-law was adopted for the purpose of preventing certain persons from joining as members of the religious society." This decision assuredly put majority rule in the saddle.

*Saltman v. Nesson*, a Massachusetts case, is very much to the point under decision as it is practically identical with the case at bar.<sup>18</sup> A by-law was enacted to prescribe a certain ritual or form of worship and also to provide that the by-laws could not be changed or amended unless by a unanimous vote of the members. The court said, "Under the statutes and certificate of incorporation, the management of corporate affairs was to be conducted reasonably by the members and the control of its business, including the form of worship and the ritual to be adopted would ordinarily be determined by a vote of the majority. The by-law assumed to put it out of the power of the corporation except by the unanimous vote of its members. We are of opinion that this was unreasonable and inconsistent with the legal right of control of the affairs of the corporation existing in its membership. If it had put a reasonable limitation upon the power to change its form of worship the by-law might have been binding, but in the form adopted it was utterly subversive of the rights of control of a corporation which belongs to its members. This part of the by-law being ineffectual to limit the right of the majority it was in

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<sup>14</sup> 223 N. Y. 313, 119 N. E. 559 (1918).

<sup>15</sup> 117 Iowa 185, 90 N. W. 717.

<sup>16</sup> *Sternaman v. Metropolitan Life Ins. Co.*, 170 N. Y. 13, 62 N. E. 763.

<sup>17</sup> 53 N. H. 187 (1877).

<sup>18</sup> See note 13 *supra*.

their power in a proper way to change the form of worship, and this was done by a vote at a regular meeting." This reasoning seems sound and incontestable, for it is based on the very essence of the corporate nature.

Like every other living organism, the corporation is of its nature subject to incessant, endless change, internal and external alike: internal because stockholders and directors themselves change. While the corporation is immortal, they are mortal. Greater still are the external changes usually beyond corporate control, requiring everlasting vigilance and readjustment, occasioned by industrial progress or industrial chaos. It may be an idea, a patent, a new invention, something intangible, as ephemeral as a by-word, or as evanescent as a passing vogue, or again it may be a tax or a tariff, a war or a famine—be it what it may, the corporate body instantly feels its impact. To avoid ruin and disaster the corporation must possess the necessary resilience to absorb the shock, and the faculty to readjust itself to changed and changing conditions. Now suppose in a corporation, grown from a handful to many thousands, it is imperative that a by-law be repealed or amended, or a new one enacted, "for the management of its business, the regulation of its affairs,"<sup>19</sup> and under an existing by-law, no action whatsoever can be taken except by unanimous consent of all the stockholders. Rarely do men, even men of affairs, see eye to eye. It may be another instance of the "recalcitrant treasurer", trying to run off with the corporate assets, or the opinionated stockholder who objects for any good reason, or as a matter of fact for no reason at all. In human affairs, unanimity, though "a consummation devoutly to be wished", is seldom achieved. Fortunately, however, there is a compensating trait in human nature that when the minority perceive their opposition will be unavailing, they good-naturedly cede, often with profound apologies, for it seems a fine thing to have a seat on the bandwagon. Thus the majority and two-thirds rule have been the twin-propellers of corporate success. Had unanimity been imposed in any phase of corporate activity their history would have made different reading, if there had been any history at all, for in human affairs unanimity because of its practical impossibility carries within itself the germ of its own dissolution.

It is needless to pursue the illustration further as the pandemonium and pantomime are amusingly set forth in the case of *Duffy v. Loft, Inc.*<sup>20</sup> With profound gravity the Chancellor said, "Reasonable rules ought to prevail in aid of the accomplishment of the statute's purposes, and a certain degree of liberality in favor of a meeting ought to prevail. To take any other view would be to encourage the prolongation of internal strife between rival factions, and keep the corporation's affairs in such a state of confusion and turmoil that the

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<sup>19</sup> N. Y. GEN. CORP. LAW § 14, subd. (5).

<sup>20</sup> *Duffy v. Loft, Inc.*, 17 Del. Ch. 140, 151 Atl. 223, *aff'd*, 17 Del. Ch. 376, 152 Atl. 849 (1930).

business it was organized to conduct will inevitably suffer to the damage of its stockholders."

Should not the same rule of reasonableness and liberality equally apply to the amending of by-laws. Damage to stockholders may easily result in the impairment of vested rights, for though the majority vote may overthrow the board of directors, it is helpless to change a by-law under which that same board must act, and in the last analysis is tantamount to having no vote at all. In the classic case of *Lord v. Equitable Life Assurance Society*,<sup>21</sup> Justice Vann said, "The right to vote for directors is the right to protect property. It is the right which gives the property value, and is part of the property itself for it cannot be separated therefrom. With the right to vote his property is safe and valuable. To absolutely deprive him of the right to vote, therefore, is to deprive him of an essential of his property." But after the right to vote for a board of directors what greater right does a stockholder possess than a right to amend the corporate by-laws under which both he and the board of directors must act. Under the rule of unanimity this right can so easily become nugatory, and the majority of the stockholders might see "the value of all they possess fading away yet would have no power direct or indirect to save themselves or the company from financial downfall."<sup>22</sup> Surely the law should not contemplate giving the minority interest, in the expressive phrase of Justice Desmond, "an absolute, permanent, all-inclusive power of veto"; which is as dangerous as it is unnecessary, and as mischievous as it is repugnant to the whole spirit of the law of corporations.

No matter how carefully you examine the New York fundamental law of corporations there is not the slightest trace of mandatory unanimity in any of its provisions. The whole spirit, purpose, and intentment seem to be to the contrary, and in one instance it goes almost to the other extreme, for while it expressly empowers the majority stock to enforce dissolution, it wisely provides that in the event of a deadlock, half the stock can exercise the same power.<sup>23</sup> Under the law a plurality elects the directors; a majority may increase or reduce the capital stock, change the number of directors or the place of business; while for the important, though isolated functions, of mortgaging the corporate property, selling its entire assets, consolidating, or extending the corporate existence, or finally dissolving it altogether, the law does not demand a unanimous vote of all the stockholders but a sensible two-thirds majority as being most in harmony with its nature and essence.

It would seem, therefore, that the principle of mandatory unanimity as applied to the amending of by-laws could become so pernicious that it would have power to deprive the corporation of its greatest and most valuable right—the right to control. Reduced to its ulti-

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<sup>21</sup> 194 N. Y. 212, 87 N. E. 443 (1909).

<sup>22</sup> *Ibid.*

<sup>23</sup> N. Y. GEN. CORP. LAW § 103.



mate analysis for all practical purposes it could change the whole character of a corporation and make of it a partnership, instead of being the trustee for the management of the property and the stockholders the mere *cestui que trust*.

We think that in the law of corporations there is no place for an unbending rule like the unchangeable laws of the Medes and Persians, and the sounder rule was expressed by Justice Lord in *Wist v. Grand Lodge*,<sup>24</sup> "Any meeting can by a majority vote modify or repeal the law of a previous meeting, and no meeting can bind a subsequent one by irrevocable acts or rules of procedure."

Of the many objections to this new rule of corporate law may we list the following:

1. The rule does not tend to strengthen the corporate structure, but on the contrary perceptibly weakens it.

2. It seems to flout the whole spirit, purpose, and intentment of the Legislature in the corporation acts.

3. Though not expressly contrary to statute, it seems inconsistent with the rule at common law which should not be made an anachronism.

4. It is not promotive of the "better government" of the corporation, and introduces a foreign element, absolutism, into the democratic corporate concept that can so easily become vexatious, arbitrary, and oppressive.

Time, the greatest of all dissenters, may vindicate once again, as so often before, the truth and wisdom of the age-old maxim *Summum Jus, Summa Injuria*.<sup>25</sup>

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<sup>24</sup> 22 Ore. 271, 29 Pac. 610 (1892).

<sup>25</sup> CICERO, DE OFFICIIS.